IN THE

Supreme Court of the United States

OCTOBER TERM, 1938.

No. 11.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

ROBERT C. WINMILL, *Respondent.*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR THE RESPONDENT.

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Opinions Below.

The opinion and dissenting opinion of the Board of Tax Appeals (R. 8-16) are reported in 35 B. T. A. 804. The opinion of the United States Circuit Court of Appeals for the Second Circuit is reported in 93 Fed. (2nd) 494.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered December 13, 1937. (R. 38-39) The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether respondent who is engaged in the business of buying and selling securities for his own account may, in determining his taxable income, deduct buying commissions in the amount of $7493.50, paid to brokers in the purchase of securities both bought and sold during the taxable year.

Statement.

In the year 1932 respondent operated three separate security trading accounts. (R. 9) During that year he sold 61,992 shares of stock through the said three accounts, the cost of which to respondent was $2,884,531.14 (R. 9) exclusive of purchase commissions which amounted to $8,911, of which $7,493.50 was paid by respondent in 1932. The 61,992 shares were sold by respondent in 1932 for $2,722,904.37, on which selling commissions were paid by respondent during 1932 in the amount of $9,574. (R. 10) The operation of these three security accounts resulted in a loss of $161,626.77 not including commissions.

At the end of the year 1932 respondent had on hand in his individual trading accounts shares of stock on which purchase commissions in the amount of $403 had been paid by him during that year. This amount is not included in the purchase commissions above described. (R. 10)

During the year 1932 respondent operated four joint stock trading accounts in which persons other than he had an interest and in which stocks and bonds were bought and sold for profit. Respondent's share in this said profit amounted to $2,267.80. None of the shares sold through any of the above seven accounts were held for two years or more. (R. 10)

In his return for the year 1932 respondent claimed a deduction (on line 8, R. 32) of $172,771.02 as losses on the sale of stocks made up as follows (See Schedule, R. 31):

Cost of stock sold in 1932 through three indivdual accounts	$2,883,773.95
Premiums paid on individual accounts, 1932	395.51
Premiums paid on individual accounts, 1932	361.68
Cost plus premiums on stock sold in 1932 on three individual accounts	$2,884,531.14
Selling price of 61,992 shares sold through three individual accounts	$2,719,760.69
Premiums received on sales through three accounts	1,929.67
Premiums received on sales through three accounts	1,214.01
Selling price, plus premiums received on sales through three accounts	$2,722,904.37
Cost as indicated above	$2,884,531.14
Selling price as indicated above	2,722,904.37
Loss on sales through three individual accounts, including tax but not including commissions	$ 161,626.77
Buying commissions on stock sold in 1932, through three individual accounts	8,911.00
Selling commissions on stock sold in 1932, through three individual accounts	9,574.00
Loss on sales through three individual accounts, including tax and commissions	$ 180,111.77
Tax paid in 1932 on 1932 sales through three individual accounts.	5,072.95
Loss on sales through three indivdual accounts including commissions but not tax (taxes claimed and allowed as deductions)	$ 175,038.82
Gain on sales through four joint stock trading accounts attributable to respondent's interest	2,267.80
Net loss claimed on 1932 return on account of three individual accounts and four joint-stock trading account	$ 172,771.02

In the said return for the year 1932 respondent included as income "Interest on Bank Deposits, Notes Corporation Bonds, etc.. (except interest on tax-free covenant bonds)" in the amount of $29,876.34. Respondent also included as "Income from Partnerships, Syndicates, Pools etc.", $27,-984.15 described as "Gude, Winmill Co., 1 Wall St., N. Y." and "Dividends on Stock of Domestic Corporations", $11,-785, thus resulting in a total loss of $103,125.53. Respondent claimed as deductions in the return "Taxes Paid" in the amount of $10,860.86 and "Other Deductions Not Reported Above", described as "Capital Loss held over 2

years", $22,560.05. The total loss reflected in respondent's return amounts to $136,546.44. (R. 32)

In the audit of the said return the Commissioner, relying on Section 23(r)(1) of the Revenue Act of 1932, added to respondent's income $175,018.67, explained as follows (R. 7):

Stock profit joint accounts	$ 2,247.65
Stock losses	172,771.02
Total	$ 175,018.67

The Commissioner thus disallowed the claimed deduction from the three separate security accounts in the amount of $161,626.77, and disallowed buying commissions in the amount of $8,911 and selling commissions in the amount of $9,574. The Commissioner also added to respondent's income the $2,247.65 "Stock Profit Joint Accounts" (included in respondent's income as the amount $2,267.80, R. 31). The Commissioner also adjusted the partnership income of $27,984.15 by decreasing such income to the extent of $8,473.06. These adjustments resulted in a deficiency in income tax for the year 1932 for respondent in the amount of $5,508.14.

Respondent contended before the Board that the $7,493.50 representing purchase commissions on securities bought and sold during 1932 and the $403 representing purchase commissions on securities bought but not sold during 1932, and the selling commissions on securities sold during 1932 in the amount of $9,574 were deductible under Section 23(a) of the Revenue Act of 1932 as ordinary and necessary expenses of carrying on the business of buying and selling securities during 1932. (R. 13, 14, 16-23) Respondent also contended that the effect of the disallowance of stock losses under Section 23(r) of the Revenue Act of 1932 resulted in the taxation of receipts not constituting income in the sense intended by the Sixteenth Amendment to the Constitution, and, therefore, that section was void as imposing a direct unapportioned tax in violation of the pro-

visions or Article I of the Constitution (R. 11, 16-23), and that the application of this limitation only to traders in stocks and bonds constituted a discrimination prohibited by the due process provisions of the Fifth Amendment to the Constitution. (R. 11, 16-23)

Respondent also argued before the Board that the $2,-247.65 item described by the Commissioner as "Stock Profit Joint Accounts" constituted respondent's individual profit from sales of stocks and bonds and was properly to be offset against respondent's losses from sales of stocks and bonds. The United States Board of Tax Appeals affirmed the Commissioner of Internal Revenue on all grounds (R. 8-15, 23), Members Arundell, Leech, Arnold, Harron and Black dissenting (R. 15, 16), affirming the addition to income of $2,247.65 described as "Stock Profit Joint Accounts" on the ground that this gain reached respondent through *joint* ventures in which others were also interested and was partnership gain as distinguished from respondent's *individual* gain in such a sense as not to be offset under Section 23(r)(1) of the Act against respondent's *individual* stock losses. (R. 12) The Board made no finding, however, as to whether respondent was engaged in the business of buying and selling securities in 1932 since it believed that in any event the commissions were not deductible. (R. 12-14)

The Circuit Court of Appeals sustained the Board on all grounds (R. 35-37) except as to commissions in the amount of $17,067.50 (R. 37, 38) ($7,493.50 plus $9,574, R. 35), no mention being made by the court of the $403 representing commissions paid on securities bought but not sold during 1932. In its opinion the Circuit Court of Appeals held that commissions were business expense and ordered that the case be remanded to the Board for a finding as to whether respondent was engaged in the business of buying and selling securities in 1932. "If so, the commission for purchases and sales are deductible." (R. 38) Earlier in its opinion the court had stated that the evidence would justify

such a finding. (R. 37) The mandate of the Circuit Court of Appeals was not stayed and on December 31, 1937 the Board of Tax Appeals pursuant to the remand found as a fact that respondent was engaged in the business of buying and selling securities in 1932. (Petitioner's brief page 7, Note 1 at bottom of page)

The petition for certiorari sought a review of the decision only insofar as it related to the commissions paid by respondent on the purchase of shares of stock in the amount of $7,493.50 on the three separate trading accounts and as to buying commissions in the amount of $270 paid by respondent in connection with four security trading accounts jointly operated with others. (Petition page 3)

Summary of Argument.

The United States Circuit Court of Appeals in allowing respondent to deduct brokerage commissions paid on the purchase of securities in the amount of $7,493.50, incident to a trade or business, correctly regarded such commissions as ordinary and necessary expenses in the form of compensation for personal services actually rendered under Section 23(a) of the Revenue Act of 1932.

The purchase commissions in the amount of $270 paid by respondent in connection with certain transactions executed jointly with others are allowable in any event inasmuch as this trading resulted in a profit. This point as to the $270 purchase commissions was not raised by petitioner before the Board or the Circuit Court and may not be raised for the first time here.

In the alternative, respondent contends that if this court should hold that the 1932 act must be construed to require that the commissions of $7,493.50 should be added to the cost of respondent's stocks and bonds sold during 1932, and increase, to that extent, the loss already disallowed under the limitation provisions of Section 23(r)(1) of the Revenue Act of 1932; then respondent urges, in support of the

judgment allowing such commissions as a deduction, that to the extent that the provisions of Section 23(r)(1) of the said Act are to be construed as disallowing these commissions, such provisions are unconstitutional and void under Article I, Section 2, Clause 3 and Article I, Section 9, Clause 4 of the Constitution of the United States for the reason that such construction of the Act has the effect of levying a direct unapportioned tax on subject matter or property not contemplated by the word "incomes" within the meaning of the Sixteenth Amendment to the Constitution, because that word as used in the Sixteenth Amendment was understood by its framers and the people who ratified it to refer to the "computation of income annually as the *net result of all transactions within the year*, (see *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365), and, further, that the said provisions of Section 23(r) are unconstitutional and void to the extent that they disallow the said $7,493.50, because they are arbitrary, capricious and whimsical, and, therefore, violate the due process clause of the Fifth Amendment to the Constitution, resulting in the imposition of a tax at progressive rates on gross receipts, improperly discriminating between persons without reference to their ability to pay, although the supposed reasonable ground for proper discrimination arising from progressive surtax rates, is their relative ability to pay.

These latter arguments are made merely to sustain affirmance of the decision of the court below.

STATUTE AND REGULATIONS INVOLVED.

Excerpts from the Revenue Act of 1932.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * *

(e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; * * *.

* * * *

(r) *Limitation on stock losses.*—

(1) Losses from sales or exchanges of stocks and bonds (as defined in subsection (t) of this section) which are not capital assets (as defined in section 101) shall be allowed only to the extent of the gains from such sales or exchanges (including gains which may be derived by a taxpayer from the retirement of his own obligations).

* * * *

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b), and the loss shall be the excess of such basis over the amount realized.

* * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

REGULATIONS.

Excerpts from Regulations 77 relating to the Revenue Act of 1932:

ART. 103. *Inventories at cost.*—Cost means:

* * * * * *

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

ART. 121. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items

which are deductible under the provisions of articles 141-272. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 55). Among the items included in business expenses are management expenses, *commissions*, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 122), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source. As to items not deductible, see section 24 and articles 281-284. (Emphasis ours)

ART. 282. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23(k) and article 201) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price * * *.

Argument.

I.

In this proceeding the only question properly before this Court is the deductibility of brokerage commissions in the amount of $7,493.50 on securities bought and sold during the year in respondent's three individual trading accounts.

At the outset it should be pointed out that the petition for certiorari sought review only as to the following specific question or matter upon which the lower court ruled:

> (1) Deductibility of brokerage commissions in the purchase of securities in the sum of $7,493.50 on the three separate trading accounts which respondent operated individually during 1932. (Petition p. 3)

The petition also sought review as to the following point or question:

> (2) Deductibility of brokerage commissions in the purchase of securities in the sum of $270 on the four security trading accounts which respondent operated jointly with other persons. (Petition p. 3)

Inasmuch as this latter point or question was not raised in this proceeding before the Board of Tax Appeals or before the Circuit Court of Appeals below, it cannot be raised by petitioner for the first time upon certiorari in this court. *Helvering* v. *Minnesota Tea Company*, 296 U. S. 378, 380, 56 S. Ct. 269, 270.

The petition for certiorari did not seek review as to any other point or matter upon which the Board of Tax Appeals or the United States Circuit Court of Appeals below ruled on. Specifically, the petition did not seek review as to the deductibility of purchase commissions in the amount of $403 which were paid on securities purchased in 1932 by respondent through his own three individual trading accounts.

The petitioner at page 7 of his brief is attempting to make it appear that the petition for certiorari embraced the question of the deductibility of the commissions in the amount of $403 which the petition actually omitted. The attempt is made to make it appear to this court that the petition sought review as to a total or lump sum, namely "$7,896.56" which petitioner explains as being "$7,493.50 plus $403". In note 2 at the bottom of page 7 of petitioner's brief it is asserted that:

> "The petition (p. 3) erroneously gives the total as $7,763.50 ($7,493.50 plus $270)."

Quite on the contrary, neither total figure was used in the petition. Two separate amounts were given with definite references to pages in the record in the court below: "$7,493.50 (R. 20)" and "$270 (R. 20)".

In the record of the court below the $403 item appears on a different page, namely page 21. (R. 10) The $270 amount according to the petition expressly refers to commissions involved in "four securities trading accounts" which respondent "operated jointly with others"; whereas those commissions are entirely different from the purchase commissions in the sum of $403, which respondent had paid in 1932 on securities on hand at the end of the year in his own "three individual trading accounts". (R. 10)

From the foregoing it is clear that the question of the action of the Circuit Court of Appeals with respect to these latter commissions ($403) was not presented by the petition for certiorari and may not be considered here. *Steel* v. *Drummond*, 275 U. S. 199, 48 S. Ct. 53; *Johnston* v. *Manhattan R. Co.*, 289 U. S. 479, 53 S. Ct. 721; *Olson* v. *United States*, 292 U. S. 246, 54 S. Ct. 704; *Prudence Company, Inc.* v. *Fidelity and Deposit Co.*, 297 U. S. 198, 56 S. Ct. 387.

For the foregoing reasons respondent will confine his brief only to a discussion of matters relating to the deductibility of brokerage commissions in the amount of $7,493.50. Inasmuch as these commissions were all paid with

respect to securities both bought and sold by respondent during the year 1932, the rule laid down by the United States Circuit Court of Appeals for the Fifth Circuit in the case of *Hutton* v. *Commissioner*, 39 Fed. (2d) 459, under the 1921 Revenue Act (42 Stat. 237) is clearly inapplicable, inasmuch as the commissions there were commissions paid on stocks bought during the year but not disposed of until a later year under a regulation which allowed them to be deducted in such later year. For this reason, as will be more particularly discussed below (pages 23-24 this brief), there is no conflict between the decision of the court below and the *Hutton case* or any other case cited by petitioner and if this court granted certiorari on the ground of such a conflict, it is respectfully urged now that the writ was improvidently granted. This contention was also urged by respondent in his brief in opposition to the petition.

II.

Compensation paid brokers for services rendered in connection with the purchase and sale of stocks in the course of the ordinary and necessary operations of a taxpayer's trade or business is deductible under Section 23 (a).

Section 23(a) of the Revenue Act of 1932 provides that there *SHALL* be deducted in computing net income, the ordinary and necessary expenses of carrying on any trade or business "*including a reasonable allowance for salaries, or other compensation for personal services actually rendered* * * * ." (Emphasis ours)

Commissions paid to brokers for effecting the purchase and sale of stocks in the course of a business, constitute "compensation for personal services actually rendered", and are, therefore, deductible under the above statute. "A merchant employing a buyer on salary would unquestionably deduct the salary as current business expense rather than allocate it as part of the cost of goods, and in sub-

stance a commission paid to a buyer is not different". Arundell's dissenting opinion, *Winmill* v. *Commissioner*, 35 B. T. A. 804, 810 (R. 15-16)

The statute, Section 23(a), creates the classification of "compensation for personal services actually rendered", and provides that such "compensation" is deductible as an expense. The *statute* mentions no more specific classification than such "compensation". The *regulations* (Article 282) create the more specific classification, or sub-classification, of compensation, namely "commissions paid in purchasing securities", and provide inconsistently with the statute that such commissions are to be capital expenditures as distinguished from ordinary and necessary expenses. This inconsistent treatment in the regulations, of the statutory classification of "compensation" is unwarranted, unless the classification of "commissions paid in purchasing securities" is justified under the more *general* statutory treatment (Section 113(b)(1)(A)) of "items, properly chargeable to capital account". But in determining whether it was the intent of Congress to govern "commissions paid in purchasing securities" by the general statutory classification, "items, properly chargeable to capital account", or by the more specific statutory classification, "compensation", the general statutory treatment of "items, properly chargeable to capital account" must yield to the more specific statutory treatment of "compensation", because we are dealing with "compensation for personal services actually rendered" in the form of commissions.

Obviously, the Commissioner is attempting, contrary to the statute, to regulate the statutory classification of "compensation" without reference to whether or not such compensation in true substance qualifies under the broader statutory phrase "items, properly chargeable to capital account"; that is to say, the Commissioner here contends that his regulations mean that *all* "commissions paid in purchasing securities" are to be capitalized and not expensed, irrespective of their being statutory compensation and re-

gardless of whether or not they are statutory "items, properly chargeable to capital account".

The words, "items, properly chargeable to capital account" have been held to include only such items as are not specifically named as deductible expenses in the statute but which are paid for increasing capital value. See *Central Real Estate Company v. Commissioner*, 47 Fed. (2d) 1036 where the United States Circuit Court of Appeals for the Fifth Circuit decided that interest and taxes paid with respect to unproductive property could not be added to the cost of such property (for the purpose of determining the gain or loss from its sale), as amounts "properly chargeable to capital account". Speaking for the Court in that case as to the meaning of the quoted phrase, Circuit Judge Foster said that it "clearly contemplated only such items as add to the value of the property". He then added:

> "If Congress had intended to give the taxpayer the privilege of adding taxes and interest to cost, it would have been very easy to have said so. As the act does not so provide, the conclusion is inescapable that Congress did not so intend."

That case was decided in 1931 under Section 202(b) of the Revenue Act of 1924 (26 U. S. C. A. §933, note), under which proper adjustment was to be made for any expenditure "properly chargeable to capital account". The words "including taxes and other carrying charges on unimproved and unproductive real property" were not included in the 1924 Act (26 U. S. C. A. §933, note), but appear *for the first time* in the 1932 Act in Section 113(b)(1)(A), which corresponds to Section 202(b) of the 1924 Act. Nor were these added words in the corresponding provisions of the Revenue Act of 1926 (26 U. S. C. A. §933) or 1928 (26 U. S. C. A. §2111). They were undoubtedly added to the law in 1932 to change the law as interpreted by the Fifth Circuit. If Congress had intended compensation in the form of commissions to be included in the phrase "prop-

erly chargeable to capital account", the words "commissions paid in purchasing securities" would undoubtedly have been added to Section 113(b)(1)(A) of the 1932 Act, because of the inclusion in Section 23(a) of "compensation for personal services actually rendered". See also *Westerfield* v. *Rafferty*, 4 Fed. (2d) 590 (D. C., E. D. N. Y.); *Fraser* v. *Commissioner*, 25 Fed. (2d) 653 (C. C. A.-2); *H. M. O. Lumber Co.* v. *United States*, 59 Fed. (2d) 907. Under this theory "finance charges" were held by the Court of Claims in *Moran* v. *U. S.*, 19 Fed. Supp. 557, as being correctly regarded as "expenses" rather than as "items properly chargeable to capital account".

Furthermore, the Commissioner's own regulations, Article 282 at the very outset define "capital expenditures" as "amounts paid for increasing capital value". "Commissions paid in purchasing securities" add nothing to the value of the securities purchased. Securities purchased directly without commissions are worth no less than the identical securities purchased through a broker to whom commissions are paid. Commissions, therefore, add nothing to the value of the asset involved, nor do the commissions here constitute "amounts paid for increasing capital value".

The recognized accounting authorities in dealing with the subject of amounts properly chargeable to capital account, invariably illustrate their texts with references to items which are clearly of a capital nature, such as buildings, machinery, and bonds purchased for a permanent investment. See Kester: Accounting—Theory and Practice, Volume 1 (3rd revised edition) page 516. None of the illustrations refer to securities bought and sold in the course of a *trade or business*. Kester, Volume 1 (3rd revised edition) page 517 treats the problem of amounts properly chargeable to capital account with respect to temporary investments of funds idle for the time being. Obviously these illustrations are also to be distinguished from securities purchased and sold by a trader such as Mr. Winmill.

was, because his securities are in the nature of inventory or merchandise items. From an accounting standpoint, therefore, it is clear that the words "properly chargeable to capital account" mean just what they say, with particular emphasis on "capital account". Bonds held for investment, annuities held for income purposes, buildings, plant equipment and the like are items that would normally go in the *capital account;* while merchandise purchased for resale in the course of business would be carried in the merchandise account as distinguished from the capital account, and a person engaged in the business of trading or buying and selling property would account for his purchases in an account comparable to the merchandise account as distinguished from his capital account. Thus, a trader in securities would not be required by the phrase "properly chargeable to *capital account*" to add his buying commissions to such an account. Buying commissions are analogous to buyers' salaries, and need not be allocated to cost of goods. The fact that they may easily be so allocated does not make it necessary to do so nor does it require the provisions of Section 23(a) to be ignored.

It has been the long established custom of the Bureau of Internal Revenue to allow buying and selling commissions as deductions when such commissions are paid with respect to property bought and sold in the course of a trade or business of the taxpayer. This practice is evidenced by the Commissioner's published ruling which is still in force, namely, I. T. 2305 published on page 108 of Cumulative Bulletin V-2. This ruling reads as follows:

> "In the case of sales of real estate by persons not regularly engaged in that business, commissions paid, while they do not reduce or otherwise affect the amount of the selling price, may be offset against the selling price in determining the amount of gain or loss realized from such sales, and in cases of installment sales in determining the percentage of profit in each installment payment which is to be included in gross income.
>
> "Dealers in real estate should deduct commissions

paid for the sale of real estate as a business expense for the year in which paid or accrued, in accordance with the basis on which their books are kept."

The allowance of commissions on real estate sales as a business expense was approved by the Board of Tax Appeals in the *Highlands Trust*, No. 1546, 32 B. T. A. 760, expressly on the authority of I. T. 2305 quoted above. In that case the taxpayer was seeking to add commissions to the cost of real estate sold during the year. This the Board refused to do saying at page 766:

"We gather from statements in the deficiency notice and the briefs of the parties that the respondent treated the commission retained by the Paramount Realty Corporation as a deductible business expense rather than as a reduction of either the selling price of the lots or the initial payment thereon. This is in accordance with the long established practice of the Bureau. See I. T. 2305, C. B. V-2, P. 108; art. 352, Regulations 74 and 77; art. 44-2, Regulations 86. Petitioners' claim, as we understand it, is that the net amount received after deducting the part retained by the Paramount Realty Corporation should be treated as the selling price. This would have the effect of throwing back into the earlier years some of the profit ultimately realized on the deferred payment sales. We know of no authority for this method of computing income. The gross amount which purchasers contracted to pay was the selling price and must be accounted for as such, regardless of bookkeeping or accounting methods. *Commissions on sales are business expenses to be deducted in the years of accrual or payment, according to whether the taxpayer is on the accrual or cash basis, and are to be deducted in arriving at net income.* This is the normal method of determining income and petitions have not shown any reason for a departure therefrom. Some argument is made as to the lack of value of the sales contracts. We do not see what this has to do with the question presented; moreover, there is no evidence at all as to the value of the contracts." (Emphasis ours)

See also *Clarence Whitman* v. *Commissioner*, 16 B. T. A. 197, 199, affirmed by this Court, 49 Fed. (2d) 1087; *Alexander Sprunt & Son* v. *Comm.*, 64 Fed. (2d) 424, 428 and *Kornhauser* v. *U. S.*, 276 U. S. 145.

The principle is equally applicable to one whose trade or business involves the purchase and sale of stocks for a profit. The buying and selling commissions constitute "compensation for personal services actually rendered", "in carrying on any trade or business", and are clearly deductible.

The Commissioner in his petition does not question the Circuit Court's ruling with respect to *selling* commissions, but only as to purchase commissions. There is no difference in principle between these two classes of commissions and there is no good reason for allowing one and disallowing the other as petitioner contends the Regulations do. The Commissioner's regulations if construed so as to allow one and disallow the other are unreasonable and should be disregarded to the extent that they are inconsistent with Section 23(a).

On page 13 of petitioner's brief, after citing in support of his position the case of *Bonwit Teller & Company* v. *Commissioner*, 53 Fed. (2d) 381, in which commissions paid to secure a 21 year lease were held to be capital expenditures deductible ratably over the life of the lease, after pointing out that the court likened such commissions to a fee paid to a broker for negotiating an annuity contract, petitioner says:

> "There appears to be no essential difference between a brokerage fee paid in the acquisition of an annuity contract and one paid in the acquisition of securities."

We believe that there would be little, if any, difference between a brokerage fee paid in the acquisition of an annuity contract and one paid in the acquisition of securities purchased as a *permanent* or *quasi permanent* investment, but when, as here, the commissions are paid in the acquisition of

securities purchased for resale by petitioner in the conduct of a trade or business of buying and selling securities, and when, as here, the securities involved in the issue were all bought and sold during the year 1932, there is no similarity between the commissions paid thereon and the amount of commissions paid in purchasing a long-term annuity, or to commissions paid to secure a lease as in the *Bonwit Teller case* with a term running for 21 years.

In the case of *Helvering* v. *Union Pacific Railroad Company,* 293 U. S. 282, referred to in petitioner's brief (pp. 11, 12), the issue involved the deduction of commissions on bonds issued by the taxpayer itself. Each of the cases cited in the margin of that case by this court in support of its tacit approval of the regulations providing for the capitalization of commissions, involved a commission paid on a clearly *capital transaction* such as a commission on the sale of capital stock being originally issued by the corporation taxpayer.

In that case this court indicated, (see 293 U. S. 282, 286, 287), as did the Circuit Court of Appeals in the *Hutton case,* that the taxpayer suffered no hardship by such a rule because the commission would be reflected against income when the securities were eventually retired or sold. The same lack of hardship is obvious in every single case relied upon by the petitioner. See *Helvering* v. *Union Pacific Co.,* 293 U. S. 282; *Bonwit Teller & Co.* v. *Commissioner,* 53 Fed. (2d) 381 (C. C. A. 2d), certiorari denied, 284 U. S. 690; *Spinks Realty Co.* v. *Burnet,* 62 Fed. (2d) 860 (App. D. C.), certiorari denied, 290 U. S. 636; *Hutchings* v. *Burnet,* 58 Fed. (2d) 514 (App. D. C.); *Commissioner* v. *Chicago Dock & Canal Co.,* 84 Fed. (2d) 288 (C. C. A. 7th); *Beneficial Industrial Loan Corp.* v. *Handy,* 92 Fed. (2d) 74 (C. C. A. 3rd), affirming 16 Fed. Supp. 110 (Del.); *Houston Natural Gas Corp.* v. *Commissioner,* 90 Fed. (2d) 814 (C. C. A. 4th), certiorari denied, 302 U. S. 722; *Baltimore & Ohio R. Co.* v. *Commissioner,* 78 Fed. (2d) 460, 463 (C. C. A. 4th); *Moynier* v. *Welch,* 97 Fed. (2d) 471 (C. C. A. 9th).

In none of these cases could the provision of prior law corresponding to Section 23(a) have been applicable, because the commissions involved were not paid in connection with the purchase and sale of property in the operation of a trade or business.

Neither these cases nor the regulations relied on by petitioner have any application to the case of commissions expended by one carrying on the trade or business of buying and selling securities.

The commissions and other expenses paid in those cases were related to essentially capital matters or were expenditures for property of a more or less permanent nature. They related to property or benefits which lasted in most cases for many years after the expenditure had been made. On the contrary, the commissions here involved were all paid in purchasing securities in the course of respondent's trade or business, all of which securities had been sold in the course of such business before the end of the year.

Even if we assume that the regulations and the decisions cited by the petitioner under laws *prior* to the 1932 act clearly prevented the deduction of commissions paid for services rendered in connection with the purchase and sale of securities in the course of the operation of a trade or business, these former regulations and decisions so holding could not be applicable under the 1932 law, because of the fundamental change effected by Section 23(r)(1).

It is true that legislative re-enactment of a statute *without change* operates as an implied legislative approval of the construction given to the statute before re-enactment, but where, as in the instant case, the statute is re-enacted with a *substantial change* which eliminates the application of a uniformly expressed ground for the previous construction, such previous construction cannot apply to the subsequent dissimilar enactment.

In *DeGanay* v. *Lederer*, 239 Fed. 568, 571, affirmed by the Supreme Court of the United States in 250 U. S. 376, the lower court said:

> "Legislative constructions of prior acts have all the value of expressions of opinion by those to whose opinions weight and importance is attached. Inasmuch, however, as such an opinion is that of an autocrat who can impose his will by changing the law, the distinction must always be observed between an opinion of what the law has been and a new enactment. If such subsequent statute gives to the prior one a meaning different from its sound meaning as judicially construed, the latter statute is a new enactment, no matter what its form."

See "Statutes" 59 Corpus Juris 1063 and 1064 indicating clearly that where the old and new statutes are essentially dissimilar, the rule that the construction placed on a former statute by the courts is impliedly adopted by the legislature when it re-enacts such statute, or enacts analogous legislation, does not apply.

Inasmuch as the regulations and decisions relied upon by the petitioner in support of his position all clearly contemplate the *eventual allowance against income* of the commissions paid in connection with capital purchases and sales, and as the court decisions cited predicate their holding on the premise of *eventual allowance against income*, the said regulations and decisions are not authority to *completely* and *forever disallow* this compensation paid in the operation of a trade or business, contrary to the plain language of Section 23(a).

The words "compensation for personal services" as used in Section 23(a) of the Revenue Act of 1932 are presumed to be used in their ordinary and usual sense and with the meaning commonly attributable to them:

> "Unless the contrary appears, statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributed to them." *DeGaney* v. *Lederer*, 250 U. S. 376 381.

In that sense and with that commonly attributable meaning, the words of Section 23(a) include compensation in the

form of broker's commissions and when such compensation is paid in connection with the purchase and sale of stocks bought and sold in the course of the ordinary and necessary operations of a taxpayer's trade or business, the statute requires that said compensation for services actually rendered "*SHALL*" be allowed as a deduction in computing income.

Petitioner argues (p. 16) that there is no reason to suppose that Congress simply by changing the *consequences* of the classification of an expense as a capital outlay, intended to modify the established classification itself.

The only court case called to respondent's attention which approves the classification under the earlier regulations is *Hutton* v. *Commissioner*, 39 Fed. (2d) 459 (C. C. A. 5) and it is significant that the court's approval thereof was *expressly* justified upon the very *consequences* of which petitioner speaks. Circuit Judge Foster in speaking for the court there said as to the classification:

> "The rule is fair and reasonable. It is clear that the taxpayer suffers no hardship by the rule, as the commission paid in purchasing the securities may be deducted from the profits or added to the losses when the securities are eventually sold." (39 Fed. (2d) 460)

To require the addition of such commissions to one's losses, when it is positive that such resulting loss will not be offset against other actual income, and the result will be that a substantial tax must be paid, which could not arise if the commissions were deductible as an *expense*, certainly constitutes a definite hardship. For this reason, therefore, the above quoted statement certainly cannot be construed as intending under the court's rule, that the losses including the commissions are to be disallowed in any event "when the securities are eventually sold".

But this taxpayer *does* suffer a hardship by application of the former rule in this case, and unless the securities, in the amount of $7,493.50, are to be deducted in 1932, the year

in which the securities were both bought and sold, respondent will never be able to deduct this out-of-pocket expense, which he incurred, in good faith, in the operation of a business, in which he was attempting to produce taxable income. If the commissions are disallowed, respondent will be required to pay a substantial tax even though his losses from these transactions exceeded his gains and income from all sources for the year. However, if the commissions are allowed as a deduction, his taxes for the year will be reduced accordingly.

There is no question of a "possibility" of a "hazard" in this case, as the petitioner terms the possibility (p. 17) that the Commissioner's capital classification rule does not always produce a hardship. In this regard he says the taxpayer may not always have other income to offset such an expenditure. But respondent answers—neither would he pay any tax. In any event, however, it is improper to discuss suppositions inconsistent with the facts here. This respondent *had* other income here, and it is *definitely certain*, in this proceeding, that he *will* suffer a hardship by the application to the new law of the regulations applicable to the former law.

In the light of the unfairness of the definite hardship which would be imposed upon respondent through the disallowance of the deduction for the commissions here in issue, the application to the facts here to the test of fairness and lack of hardship, upon which Circuit Judge Foster's opinion in the *Hutton case* was predicated, would lead inescapably to the allowance of the commissions as expenses. Therefore there is no conflict between that decision and the decision of the Circuit Court in this proceeding.

It is perhaps not without significance that Circuit Judge Foster in rendering the opinion of the court in *Central Real Estate Co.* v. *Commissioner, supra,* refused to permit interest and taxes on unproductive property to be capitalized in determining the gain or loss from the sale of the property because interest and taxes were deductible as an ex-

pense under the Act. In view of this decision, which was rendered just a little less than a year after the decision of the same court in the *Hutton case*, it may be assumed that the Fifth Circuit has now modified its view formerly expressed in the *Hutton case*.

The Commissioner's Regulations, Article 282 specifically recognize that commissions paid in selling securities may sometimes represent an ordinary and necessary expense of doing business by the following provision in that Article:

> "Commissions paid in selling securities, *when such commissions are not an ordinary and necessary business expense*, are an offset against the selling price." (Emphasis ours).

The only reasonable inference from this statement is that when such commissions *are* an ordinary and necessary business expense, they are deductible as such. No similar distinction is made in the Regulations, between buying commissions which *are* and buying commissions which are *not* ordinary and necessary business expenses. There is no reason for holding that commissions paid in *selling* securities may be an ordinary and necessary business expense, but that *all* commissions paid in *purchasing* securities are to be capitalized whether or not they constitute ordinary and necessary business expenses. To the extent that Article 282 of the Regulations fails to recognize that commissions paid in purchasing securities which are ordinary and necessary business expenses, may not be deducted as such expenses, the Regulation is contrary to Section 23(a) and is otherwise wholly unreasonable and arbitrary.

Finally, it is significant to consider that the provisions of Section 23(r) limiting losses on stocks, constitute an express limitation only on Section 23(e)—Losses, and not a limitation on Section 23(a)—Expenses, or any other section. Thus is must be presumed that Congress clearly intended not to limit the expenses incident to carrying on the business of trading in stocks (or the expenses of any other

business) to be limited by Section 23(r). If Congress had intended to extend the limitation of Section 23(r) to expenses provided for in Section 23(a) it would have said so *specifically* and would have provided definite cross references between Section 23(a) and Section 23(r) as it did between Section 23(e) and Section 23(r).

If there is any doubt about this matter, that doubt should be resolved in favor of the taxpayer. The limitation in Section 23(r) should not be *extended* by *implication* to override the specific provisions of Section 23(a). In *Gould v. Gould*, 245 U. S. 151, 38 S. Ct. 53, this court said:

> "In the interpretation of statutes levying taxes it is the established rule not to *extend* their provisions, by *implication, beyond the clear import of the language used*, or to enlarge their operations so as to embrace matters *not specifically pointed out*. In case of doubt they are construed most strongly against the government, and in favor of the citizen." (Emphasis ours)

III.

If the commissions are not deductible as ordinary and necessary expenses, they are deductible as losses under Section 23 (e) (1) of the Revenue Act of 1932.

Even if it should be held by this court that the commissions constitute "items properly chargeable to capital account", the amounts paid, therefore, are expenditures made in good faith to produce taxable income and when the securities upon which they are paid have been disposed of, the taxpayer has nothing left to show for this expenditure. Thus, the amount so expended becomes a loss deductible under Section 23(e)(1) of the Revenue Act of 1932 for losses "if incurred in trade or business". If these commissions are properly to be considered a part of the taxpayers losses, such losses are not "losses from sales or exchanges of stocks and bonds (as defined in sub-section (t) * * *)". The definition of stocks and bonds contained in Section 23 (t) of the Revenue Act of 1932, although very explicit, con-

tains no reference whatsoever to commissions. It must be presumed, therefore, that Congress did not intend to disallow losses to the extent that they represent commissions paid. It would require clear and unequivocal language to hold that commissions were intended to be included by the definition of stocks and bonds in Section 23(t). The definition reads as follows:

> "(t) DEFINITION OF STOCKS AND BONDS.—As used in subsection (r) and (s), the term 'stocks and bonds' means (1) shares of stock in any corporation, or (2) rights to subscribe for or to receive such shares, or (3) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation other than a government or political subdivision thereof), with interest coupons or in registered form, or (4) certificates of profit, or of interest in property or accumulations, in any investment trust or similiar organization holding or dealing in any of the instruments mentioned or described in this subsection, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act."

IV.

To the extent that Section 23(r) of the Revenue Act of 1932 may be held by this court to disallow the buying commissions in the amount of $7,493.50, such Section is unconstitutional and, void under Article I, Section 2 Clause 3 and Section 9, Clause 4 of the Constitution, because as so construed the Act levies a direct unapportioned tax on subject matter not contemplated by the word "incomes" within the meaning of the Sixteenth Amendment to the Constitution.

Solely in the alternative and to support the judgment of the court below in allowing the buying commissions in the amount of $7,493.50 to be deducted, respondent contends that if this court should hold that the Revenue Act of 1932 must be construed so as to require that the said purchase

commissions should be added to the cost of respondent's stocks and bonds (held less than two years and sold in 1932) and so increase, to that extent, the large loss already disallowed under the limitation provisions of Section 23(r)(1) of the Revenue Act of 1932, then respondent urges in support of the judgment that to the extent that the provisions of the said section require the disallowance of the said expenditure of $7,493.50, to that extent the Act is unconstitutional and void under Article I, Section 2, Caluse 3 and Article I, Section 9, Clause 4 of the Constitution of the United States, for the reason that so construed, the Act has the effect of levying a direct unapportioned tax upon subject matter or property not contemplated by the word "incomes", within the meaning of that word as used in the Sixteenth Amendment to the Constitution.

Respondent would have filed a cross petition for certiorari as to this issue, but as a computation under the judgment below reflects a deficiency of only about $700.00 and as respondent was absent from the country during the time between the filing of the petition herein and the expiration of the time for filing cross petition, he must content himself with raising the issue only as an alternative and in support of the judgment below. Nothing said herein is intended to be construed as an attack upon that judgment.

Before the adoption of the Sixteenth Amendment to the Constitution, Congress was without practical power to tax incomes, without apportionment according to the population. It was held in the case of *Pollock* v. *Farmers' Loan and Trust Company*, 157 U. S. 429, that an income tax is a direct unapportioned tax and that the imposition of direct unapportioned taxes was specifically prohibited by Article I, Section 2, Clause 3 of the Constitution and because, Article I, Section 9, Clause 4 of the Constitution required that all direct taxes be apportioned according to the population.

By the Sixteenth Amendment, the necessity for apportioning "incomes" was done away with, but the prohibition

in Article I, Section 2, Clause 3 against unapportioned direct taxes not covered by the Sixteenth Amendment remained, as did the requirement of Article I, Section 9, Clause 4 of the Constitution that direct taxes be apportioned.

Thus after the amendment, the necessity for apportionment remained with respect to all direct taxes except whatever the framers of the Constitutional amendment meant by "incomes, from whatever source derived".

The sense in which these words were used constitutionally, in the light of, (a) the history of income taxation, (b) in the light of the events leading up to and the purpose of the adoption of the Sixteenth Amendment, (c) in the light of the retained Constitutional restrictions against other unapportioned direct taxes, and (d) in the light of the Supreme Court's definition of the word "incomes", must be considered in order to know the extent to which direct unapportioned taxes may be constitutionally imposed under the Sixteenth Amendment.

Specifically, the question resolves into this query: does the word "incomes" as used in the Amendment mean, (a) the substantial equivalent of net income in an economic sense, (b) gross receipts, or (c) anything which Congress might choose to call income?

The history of income taxation in the United States reflects the fact that the taxation of incomes, computed annually upon the *net result of all transactions within the year*, was a familiar practice before the adoption of the Amendment, (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359), and that the Amendment was adopted to meet the decision of the United States Supreme Court in *Pollock* v. *Farmers' Loan and Trust Company*, *supra* (declaring the income tax law of August 15, 1894, to be unconstitutional as a direct unapportioned tax), so as to empower Congress to levy a tax like the 1894 income tax law.

This act of 1894 imposed a tax upon the substantial equivalent of net income in an economic sense and com-

puted "incomes" upon the *net result of all transactions within the year.* The definition of income in section 28 of that act included the following formula:

> "In computing *incomes* the necessary expenses actually incurred in carrying on any business, occupation, or profession shall be deducted * * * also *losses actually sustained during the year, incurred in trade.*" (Emphasis ours)

Note that the word "*incomes*" is spelled plurally as it is in the Sixteenth Amendment.

The procedure, under which the Sixteenth Amendment was adopted, was instituted under Article II, Section 3 and Article V of the Constitution, by President Taft's formal message on the State of the Union which he addressed to Congress on June 16, 1909. This message resulted in the joint resolution of the Senate and the House which, upon its ratification by the legislatures of three-fourths of the states, became the Sixteenth Amendment to the Constitution. At the time of this message there was pending in Congress a bill for the imposition of a tax upon the substantial equivalent of net income in an economic sense, which provided that "incomes" should be computed *upon the net result of all transactions within the year.*

The President's message requesting the adoption of a Constitutional amendment, which would give Congress the power to impose taxes upon incomes, without apportionment stated that there was then pending in Congress a bill for the collection of:

> "a general income tax, in form and substance of almost exactly the same character as that which in the case of *Pollock v. Farmer's Loan & Trust Company* (157 U. S. 429) was held by the Supreme Court to be a direct tax, and therefore not within the power of the Federal Government to impose unless apportioned among the several States according to population."

After pointing out that he believed that the National Government ought to have such power the President's message continued,

> "I therefore recommend to the Congress that both houses, by a two-thirds vote, shall propose an amendment to the Constitution conferring the power to levy an income tax upon the National Government without apportionment, among the States in proportion to population.
>
> * * * I have become convinced that a great majority of the people of this country are in favor of vesting the National Government with power to levy an income tax, and that they will secure the adoption of the amendment in the States if proposed to them."

The bill referred to by President Taft in his message was H. R. 110 (61st Congress, First Session). This bill was introduced by Representative Cordell Hull of Tennessee on March 15, 1909. This bill, like the Revenue Act of 1894, provided an income tax upon the *net result of all transactions within the year*. Section 2 of that bill provided that:

> "In computing incomes the necessary expenses actually incurred in carrying on any business, occupation, or profession shall be deducted, * * * also *losses actually sustained during the year, incurred in trade* * * *." (Emphasis ours.)

This bill failed of passage probably because it was believed that it would be declared unconstitutional as in the case of the 1894 Act.

Thus it is clear that the scheme of taxation which the proponents of the Amendment wished Congress to be empowered to enact, was a tax upon the substantial equivalent of net income in an economic sense computed upon the basis of the net result of all transactions within the year. During the debates there was continually held up to Congress the 1894 law as the specific pattern to illustrate the sort of power which was desired.

All through these discussions of the proposed amendment, it was indicated that the power sought to be delegated was the power to impose a *net* income tax. References to the "net income tax" (Cong. Rec. Vol. 44, p. 4393), the "fairness" of the income tax (Cong. Rec., Vol. 44, p. 4392), and to the "equity of an income tax" (Cong. Rec., Vol. 44, p. 4398), indicate that the familiar *net* income tax as then understood was all that was wanted.

Representative Champ Clark of Missouri said:

> "My own judgment is that the wit of man never devised a fairer or juster tax than a graduated income tax." (Cong. Rec., Vol. 44, page 4392.)

He further said (at page 4393):

> "But I say that when a man's *net* income rises above $100,000 a year it does not make any difference to him, practically, whether you *take* one per cent., two per cent., five per cent., or twenty-five per cent. as they do in Germany." (Emphasis ours.)

Representative De Armond in explaining his vote for the Amendment Resolution said: "There is no good reason why taxation should not be *according to ability to pay.*" (Emphasis ours.) (Cong. Rec., Vol. 44 top of page 4420.)

Representative Hobson said: "Taxes upon incomes represent the least burdensome of all taxes on wealth, and the burdens decrease with the size of the income." (Cong. Rec. Vol. 44 p. 4430.)

All the discussions centered around getting a delegation of power to pass a *net* income tax like the Act of 1894. The constant fear was expressed that the ratification by the necessary three-fourths of the States might fail due to opposition. (Cong. Rec. Vol. 44, p. 4419.) A bitter controversy did arise concerning its ratification (Cong. Rec. Vol. 44, p. 1694) and the States took longer to ratify that amendment than any other amendment except the Eleventh which was ratified one hundred and fifteen years before. If it had

been publicly understood while ratification was pending that the power sought, included the power to tax gross receipts representing in part a return of capital, or the power to tax a person who had sustained a net loss, ratification certainly would have failed. See Congressional Record, Volume 44, pages 1533 to 1542, 1558 to 1566, 1568 to 1570, 3377, 3900, 4067, 4105 to 4121, 43[illegible] to 4441 and Volume 45, pages 1694 to 1699, 2245 to 2247, and 2539 to 2540. Never once was it stated that the power sought involved the taxation of gross receipts or *gross* income as distinguished from *net* income. Never once was it suggested that deductions to arrive at the income that could be taxed would be a matter of "legislative grace".

It is not to be supposed that the amendment sought under these circumstances contemplated a surrender by the people to the Federal Government of the power to enact a scheme of taxation fashioned along unfamiliar lines or lines undisclosed during the discussion of the joint resolution. *Burnet* v. *Sanford & Brooks Co., supra.* The only publicly disclosed purpose was limited to the power to impose a tax upon the substantial equivalant of net income in an economic sense, computed upon the basis *of the net result of all* transactions within *the year*. This single purpose guided Senator Brown in the drafting and redrafting of the resolution. This purpose was before both houses of Congress when the resolution was adopted and was certainly known by the legislatures of the several states which ultimately voted its ratification as an amendment to the Constitution.

As to the effect upon the construction of an amendment to a Constitution in the light of the history of the circumstances attending its drafting and adopting, see *Loring* v. *Young,* 239 Mass. 349, 132 N. E. 65; also, *Pollock* case, 158 U. S. 601, 619.

The presumption therefore is clear that the power of taxation sought to be so delegated to Congress was to be fashioned after the scheme of taxation which had been in actual operation within the United States before the amend-

ment. The single purpose was to constitutionally legalize that same scheme of taxation which had been the "familiar practice" before the amendment. That scheme involved the imposition of a tax upon the substantial equivalent of net income in an economic sense, computed upon the basis of the net result of all transactions within the year and recognized losses sustained in trade.

It is not to be assumed loosely that any different (and hence greater) power was intended to be delegated than what was familiar, what was known and what was disclosed as the purpose. This precise thought was expressed by this court in *Burnet* v. *Sanford Brooks Co.*, 282 U. S. 359, when the court said at page 365:

> "The computation of income annually as the *net result* of *all transactions within the year* was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment, (Bowers v. Kerbaugh-Empire Co., *supra*, page 174 of 271 U. S., 46 S. Ct. 449; Pacific Insurance Co. v. Soule, 7 Wall. 433, 19 L. Ed. 95; Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 630, 15 S. Ct. 912, 39 L. Ed. 1105.) It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before it adoption." (Emphasis ours.)

The power to impose a gross receipts or *gross* income tax is so fundamentally different—greater—more confiscatory unfair, unjust and inequitable than the power to impose a mere *net* income tax, that it is unthinkable that the approval of the request for a power to impose the lesser tax should, (without some clear and definite expression of intention to authorize such a tax) result in the delegation of power to impose the greater, unfamiliar and undisclosed plan of taxation.

The "difference" between a gross receipts tax and a net income tax is "manifest and substantial". The former is a

capital tax, because it applies without reference to "ability to pay". See the discussion of this difference in *United States Glue Company* v. *Town of Oak Creek* 247 U. S. 321, 328, quoted on page 53 of this brief. The latter possesses the *equitable* quality of being payable out of income without impairing capital. This latter quality was stressed in the Congressional debates in defense of the proposed amendment.

The foregoing argument is even more strongly applicable because of the fact that the amendment is in derogation of a fundamental requisition of the original Constitution, "a fundamental requisition deemed so important as to be enforced by two provisions, one affirmative and one negative" (namely, Article I, Section 2, Clause 3, Article I, Section 9, Clause 4). *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 628, 55 S. Ct. 912, 917.

In construing an amendment to the Constitution, the Court should keep in view the Constitution as it was before it was amended, the purpose to be sought by the Amendment and the specific terms thereof. *Farrell* v. *Keel*, 105 Ark. 380, 161 S. W. 269.

Having in mind that the Sixteenth Amendment, insofar as it is applicable at all, is definitely inconsistent with and in derogation of the two specific provisions of the Constitution referred to above, the meaning of the word "incomes" as used in the Amendment may not be extended by implication beyond the purpose publicly understood in the proceeding on the resolution which resulted in the Amendment. Fundamental rights of the people are not to be deemed surrendered by mere implication. Therefore, "this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal". *Eisner* v. *Macomber*, 252 U. S. 189, 206.

The repeal of constitutional provisions by implication is not favored and an amendment should not be construed as affecting any greater innovation of the existing Constitution than is reasonably *necessary* to accomplish the *purpose* of its enactment. (12 C. J. page 710.)

> "Words or terms used in a constitution which is dependent upon a ratification by the people, must be interpreted in a sense most obvious to the common understanding at the time of its adoption." *State* v. *Butler*, 70 Fla. 102, 133, 69 S. 771.
>
> "Constitutions being the result of a popular will, the words used therein are to be understood ordinarily in the sense that such words convey to the popular mind." *State* v. *Lister*, 91 Wash. 9, 14, 156 P. 858. See also *Prigg* v. *Pennsylvania*, 16 Pet. (U. S.) 539, 610, 10 L. Ed. 1060.

At the time of the ratification of the Sixteenth Amendment the sense in which the word "incomes" was most obvious to the common understanding and the sense in which that word was conveyed to the popular mind was in the sense of net income, profit or gain "upon the *net* result of *all* transactions within the year," (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365) like the subject matter of the 1894 Act. A gross receipts tax was not being considered. It was not intended.

In construing the meaning of the word "income" as used in Section 38 of the Act of August 5, 1909 (36 Stat. 112) passed before the adoption of the Sixteenth Amendment, this court in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, 34 S. Ct. 136, 140, in defining the word "income" said:

> "* * * 'income' may be defined as the gain derived from capital, from labor, or from both combined, * * *."

This first broad definition of the word "income", was repeated by this court in *Doyle* v. *Mitchell Brothers Company*, 247 U. S. 179, 185, 38 S. Ct. 467, 469 and again in

Eisner v. *Macomber*, 252 U. S. 189, 207, 40 S. Ct. 189, 193, this court in applying this *identical definition* of "income" to the word "incomes" as used in the *Sixteenth Amendment to the Constitution, added* immediately after the exact quotation of the above definition from *Stratton's Independence* v. *Howbert* (*supra*) and *Doyle* v. *Mitchell Brothers Company* (*supra*) the language:

> "provided it be understood to include profit gained through a sale or conversion of capital assets to which it was applied in the Doyle Case, * * *."

This court's complete definition of the word thereafter has been repeatedly stated as follows:

> "After full consideration, this Court declared that income may be defined as gain derived from capital, from labor, or from both combined including profit gained through sale or conversion of capital." *Bowers* v. *Kerbaugh-Empire Company*, 271 U. S. 170, 174, 46 S. Ct. 449, 451.

Thus in order to determine whether the *combined* uses of *all* of respondent's labors and capital resulting from *all* transactions within the year 1932 resulted in "gain" or "income" so as to be subject to tax without apportionment, none of the activities or uses of his capital or labor or both combined may be arbitrarily ignored without doing violence to "incomes" in the constitutional sense intended by the Sixteenth Amendment.

The provisions of section 23 (r) of the Revenue Act of 1932 necessarily require that substantial uses to which respondent put his capital and labor be ignored for the purpose of fixing the subject matter of the tax, with the result that, although his uses of his capital and his labors for the year resulted, not in income, but in a *loss* of more than $145,000.00, the statute taxes that loss as though it were income: Our challenge, however only goes so far as the Commission in the amount of $7,493.50 are regarded by this Court as disallowed by the statute.

An unapportioned tax on such a substantial loss is a tax upon gross receipts representing a return of capital. It is thus a direct tax on that capital and being unapportioned is therefore void under the prohibition of Article I, Section 2, Clause 3 and Section 9, Clause 4 of the Constitution.

In *Bowers* v. *Kerbaugh-Empire Co.* (*supra*), the defendant in error had borrowed from 1911 to 1913 from a bank and loaned to its subsidiary approximately two million dollars in United States currency giving therefor its notes which it paid off in 1921 with depreciated German marks purchased for a comparatively small amount in United States currency. The money so borrowed had been advanced to its subsidiary for certain construction work which resulted in a total loss and no part of the advances were ever recovered by the defendant in error from its subsidiary. The Government contended that the difference between the amount actually borrowed and the actual cost of its repayment in United States currency was income in the constitutional sense, arguing that the Supreme Court should look only at that portion of the entire series of transactions there which involved gain, that it should ignore that portion of the transactions which involved the use of the gain to recoup its losses previously sustained and that it should ignore the fact that the entire series of transactions resulted in a loss.

The Supreme Court refused to ignore any part of the entire transaction and after emphasizing the required limitation under the Sixteenth Amendment to "put on the same basis all 'incomes' from whatever source derived." said: (271 U. S. 170, 174)

> "In determining what constitutes income substance rather than form is to be given controlling weight. *Eisner* v. *Macomber*, *supra*, (40 S. Ct. 189).
>
> "The transaction herein question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of cap-

ital. The essential facts set forth in the complaint are the loans in 1911, 1912, and 1913, the loss in 1913 to 1918 of the moneys borrowed, the excess of such losses over income by more than the item here in controversy, and payment in the equivalent of marks greatly depreciated in value. *The result of the whole transaction was a loss.*" (emphasis ours).

In the above decision the Supreme Court did not call the "cash gain" there statutory "gross income" and justify the elimination of the tax on the theory of some specific *statutory* deduction. After pointing out that "income" in the Constitution means the same as "income" under the 1909 Act, it specifically justified its conclusion on the view that "income" in the constitutional sense must be "income" in "substance" as determined by "the result of the whole transaction".

Although the statute provided no specific deduction to create the offset, the Court found in effect that "income" in the constitutional sense *implies* an offsetting of losses against gains that looks to the "substance" or the net "result of the whole transaction". In other words, if the statute does not specify the deduction necessary to result in the taxation of *NET INCOME IN A SUBSTANTIAL ECONOMIC SENSE* the Constitution will require such an offset or deduction by implication to bring about that result.

On page 17 of petitioner's brief it is argued "that deductions are a matter of legislative grace, *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440". This thought suggests the view which has been sometimes adopted that these same contentions were rejected in the case of *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1, 36 S. Ct. 236, and in the case of *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 36 S. Ct. 278.

Let us review this thought further. The case of *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, was authority before the Sixteenth Amendment for the view that the character of a tax on an income as direct or

indirect in the constitutional sense was to be determined by the nature of the property which was the source of the income and that, a tax on the income from real or personal property was in substance a tax on the property itself. Therefore because a tax on the property would be a direct tax, a tax on the income would thus also be a direct tax and void for want of apportionment.

As stated more recently by this Court in *National Life Insurance Co.* v. *United States,* 277 U. S. 508, 521, 48 S. Ct. 591, 593:

> "It is settled doctrine that directly to tax the income from securities amounts to taxation of securities themselves, Northwestern Mutual Life Ins., Co. v. Wisconsin, 275 U. S. 136, 48 S. Ct. 5, 72 L. Ed. 202 (November 21, 1927)."

After the Amendment, in *Brushaber* v. *Union Pacific Railroad Co., supra,* and *Stanton* v. *Baltic Mining Co., supra,* it was contended that 1913 income tax was unconstitutional, among other things, because the amendment authorized only a particular character of direct tax without apportionment, and, therefore, if a tax is levied under its assumed authority which does not partake of the characteristics exacted by the amendment, it is outside the amendment and is void as a direct tax in the general constitutional sense, because it is not apportioned. This Court in rejecting this contention also clearly repudiated its former reasoning in the *Pollock* case by which it had reached the conclusion that a tax upon income was not an excise but was equivalent to a tax on the property itself and, hence, a direct tax. In rejecting this former theory, this Court termed it "a mistaken theory deduced from the origin or source of the income taxed." *Stanton* v. *Baltic Mining Co., supra,* 240 U. S. 103, 113, 114, 36 S. Ct. 278, 281.

Mr. Chief Justice White in rendering the opinion of the Court said at the same point, that independently of the effect of the Sixteenth Amendment, an income tax on the

product of a mine, like the corporation excise tax, which levied a tax on doing business and measured it by income, was "not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations." But his reasoning in rendering the opinions of the Court in neither the *Brushaber* case, *supra*, nor the *Baltic Mining Co.* case, *supra*, squarely met or disposed specifically of the thought that if the thing sought to be taxed without apportionment was not *income* in the constitutional sense, but was to any extent property, to that extent a tax thereon would be a direct tax and void for want of apportionment. His reasoning instead criticized the argument along with all the other contentions of the taxpayers on the ground that if acceded to the argument would cause one provision of the Constitution to destroy the other, and further, that the tax authorized under the amendment being direct would come neither under the uniformity nor apportionment rules thus giving power to impose unequal taxes in different states.

He also stated:

> "There is no escape from the conclusion that the amendment was drawn for the purpose of doing away for the future with the principle upon which the Pollock case was decided; that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment." *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1, 18, 36 S. Ct. Rep. 238, 241, 242.

In *Eisner* v. *Macomber*, 252 U. S. 189, 205, 206, 40 S. Ct. 189, 192, 193, Congress had sought to tax stock dividends without apportionment under the supposed authority of the

Sixteenth Amendment as though stock dividends in reality constituted income in the sense used in the Amendment. The issue there as in the *Brushaber* case and *Baltic Mining Co.* case, was whether by virtue of the Sixteenth Amendment Congress has the power to tax as income and without apportionment something (a stock dividend) received by the taxpayer which is not "income" in the sense of the Amendment. The receipts sought to be taxed in the *Brushaber* and *Baltic Mining Co.* cases constituted receipts representing in substantial part a return of capital.

It is believed that if the broad observations and reasoning applied by this court in the *Brushaber* and *Baltic Mining Co.* cases, *supra*, had been followed, the similar contention raised by the taxpayer in the *Macomber* case would have been rejected. However, this court in the *Macomber* case clearly adopted reasoning which it had broadly rejected in the *Brushaber* and *Baltic Mining Co.* cases and also reaffirmed its view in the *Pollock* decisions to the extent not affected by the Amendment. It held in effect that its decision there was only affected by the Amendment to the extent that the thing sought to be taxed was *income*. This court said in the *Macomber* case, *supra* (252 U. S. 189, 205):

> "The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the Amendment was adopted. * * *
>
> "A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.
>
> "In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes

> essential to distinguish between what is and what is not 'income', as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

Thus did this court clearly and emphatically adopt as its views contentions which it had rejected along with others in the *Brushaber* and *Baltic Mining Co.* cases, *supra.*

So long as the deductions allowed result "in computing incomes" not substantially greater than the economic income of the year as the result of *all* the *transactions*, such deductions are matters of clear constitutional right. But as to deductions exceeding those necessary to produce the equivalent of economic income within the year from *all transactions*, such deductions are clearly matters of "legislative grace". An example of such deductions is the deduction "for losses suffered in an earlier year" as in the case of *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788. Such deductions place a tax on less income than the taxpayer had and do not result in taxing something which exceeds income in the constitutional sense. Further illustrations of allowances which are matters of "legislative grace" are personal exemptions, contributions, casualty losses in no way related to income and other allowances amounting to a privilege having no relation to income in the economic sense. Naturally, all the ordinary and necessary expenses incurred in getting the so-called gross income are of the kind to which taxpayers are entitled as a matter of constitutional right.

This court rejected the "legislative grace" theory of deductions in *National Life Insurance Co.* v. *United States*, 277 U. S. 508, 520, with the following words:

> "The suggestion that, as Congress may or may not grant deductions from gross income at pleasure, it can

deny to one and give to another, is specious, but unsound."

It must be recognized that in computing net income a formula must be used which will be composed of some elements not susceptible of exact computation without prohibitive and burdensome cost. Deductions for depreciation and depletion represent two such elements. Practical substantial accuracy in reflecting these elements as an offset to gross income is all that is necessary. Exact accuracy is probably impossible. Failure of the taxing act to use a formula made up of *exact* elements in all respects does not result in taxing something other than constitutional income. Nor does the inclusion in income, by such a formula, of items of adjustment intended to produce a more substantial equivalent of net income in an economic sense take the resulting subject matter out of the category of the income intended by the Constitution. Thus, in the case of *Helvering* v. *Independent Life Insurance Company*, 292 U. S. 371, the addition to income, for this purpose, of the adjustment of 4 per cent of the book value of real estate owned and occupied has the effect only of producing something more nearly approximating the equivalent of net income in an economic sense.

In all the cases where this court has broadly stated or implied that deductions are a matter of "legislative grace" since its decision in *Eisner* v. *Macomber*, *supra*, the deductions claimed were of the character which were not necessarily allowable in order to arrive at the substantial equivalent of economic income computed as the net result of all transactions within the year. Any apparent expression to the contrary in such cases which might have been included in the language of this court in any one of the cases is merely *obiter dictum* and was not necessary to the conclusion reached by the court in the case.

The words "*obiter dictum*" mean a remark by the way. Such an expression constituting "*obiter dictum*", while en-

titled to respectful consideration as expressing the view of the judge by whom it was uttered, is not binding as authority within the *stare decisis* rule. In *Humphrey's Executor* v. *United States*, 295 U. S. 602, 626, 55 Supreme Court 869, 873, a portion of the opinion of Chief Justice Marshall in *Cohens* v. *Virginia*, 6 Wheat. 264, 399 was quoted as follows:

> "It is a maxim, not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit, when the very point is presented for decision. The reason of this maxim is obvious. The question actually before the court is investigated with care, and considered in its full extent. Other principles which may serve to illustrate it, are considered in their relation to the case decided, but their possible bearing on all other cases is seldom completely investigated."

If the dictum in *Helvering* v. *Independent Life Insurance Company*, *supra*, were to be applied to its fullest extent we believe, it would have the effect of nullifying what this court said in *Eisner* v. *Macomber*, 253 U. S. 189, 206 about defining income so as to circumvent the Constitution.

The thought suggested in the *Brushaber* case, *supra* (pp. 40-41 of this brief) that the 1913 Act taxing income was merely an excise tax and could be justified without reference to the Sixteenth Amendment, regardless of whether the tax was levied in the form of an excise (a tax on "doing business" *measured* by income) or in the form of a direct tax on income itself, is inconsistent with the theory of the *Pollock* case, *supra*, from which this court departed in the *Brushaber* case, but to which it returned again, we believe, in the case of *Eisner* v. *Macomber*, *supra*. The Revenue Act of 1932 is in the form of a direct tax upon what is supposed to be income. In this regard it is in the same form as were the Acts of 1894 and 1916. The form taken by

these three acts is that of a direct tax upon the subject matter of income as distinguished from the form of an excise on doing business *measured* by income, as in the case of the 1909 corporation excise tax law. Thus, if by virtue of Section 23 (r) (1) the Revenue Act of 1932 imposes a tax on receipts, this is in form a direct tax on the receipts themselves and is not in the form of an excise upon the act of receiving. In any event, however, a constitutional limitation may not be refined away by finespun distinctions which result in permitting by an indirect process the doing of substantially the same thing which is prohibited to be done directly.—*Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 581, 15 S. Ct. 673, 689; *Brown* v. *Maryland*, 12 Wheat. 419, 444; *Cook* v. *Pennsylvania*, 97 U. S. 566.

In *Brown* v. *Maryland*, *supra*, Chief Justice Marshall in delivering the opinion of the court said at page 444 of 12 Wheat.:

> "But if it should be proved that a duty on the article itself would be repugnant to the constitution, it is still argued that this is not a tax upon the article, but on the person. The state, it is said, may tax occupations, and this is nothing more.
>
> "It is impossible to conceal from ourselves that this is varying the form, without varying the substance. It is treating a prohibition which is general, as if it were confined to a particular mode of doing the forbidden thing. All must perceive that a tax on the sale of an article imported only for sale, is a tax on the article itself."

Again, as late as 1935, this court said in *Stewart Dry Goods Co.* v. *Lewis*, 294 U. S. 550, 556, 55 S. Ct. 525, 528:

> "In connection with other provisions of the fundamental law, this court has had occasion to analyze similar acts. In Brown v. Maryland, 12 Wheat. 419, 6 L. Ed. 678, a tax on the occupation of an importer was held a tax on imports obnoxious to the commerce clause. Said the court (page 444 of 12 Wheat.): 'It is impossible to conceal from ourselves, that this is varying the

form, without varying the substance. * * * All must perceive, that a tax on the sale of an article, imported only for sale, is a tax on the article itself.' In Cook v. Pennsylvania, 97 U. S. 566, 24 L. Ed. 1015, a tax on the amount of an auctioneer's sales was declared a tax on the goods sold. In Crew Levick Co. v. Pennsylvania, 245 U. S. 292, 38 S. Ct. 126, 62 L. Ed. 295, a state tax on the business of selling goods in foreign commerce, measured by gross receipts from goods so sold and shipped, was pronounced an impost upon exports."

Therefore, this court, in *Eisner v. Macomber, supra,* for example, did not approve of the 1916 tax on stock dividends as being an excise upon the act of receiving them, but it declared the Act unconstitutional as a direct tax prohibited by Article I of the Constitution and beyond the subject matter sought to be excepted from Article I by the Sixteenth Amendment.

One of the reasons which prompted Congress to include in the 1932 Act the provisions of Section 23 (r) (1) was:

> "Many taxpayers have been completely or partially eliminating from tax and income some salaries, dividends, returns, etc., by deducting therefrom losses sustained in the stock and bond markets, with serious effect upon the revenue." (See report of the House Ways and Means Committee, page 12, and Senate Finance Committee, page 17, on the 1932 Revenue Bill)

In times of depression the national income will not produce the revenue that it will in times of prosperity. Thus, in times of depression the revenue must be augmented either by increasing the rate of tax or by imposing other taxes which are within the power of Congress. But in such times when an income tax has proved an unsatisfactory revenue producer, it is not proper for Congress to augment the revenue by a tax in the guise of a tax on income by defining income so as to levy a tax on something which is not income. If, for example, a taxing authority has the constitutional power to levy a direct tax on apples, but not on

other fruit, and finds the apple crop in a particular year grossly inadequate to take care of its revenue requirements for which this tax had normally been used it would not be within the Constitutional power of that taxing authority to define apples so as to include lemons for the purpose of augmenting its otherwise insufficient revenue under the law.

This, we believe, is just what Congress did in the 1932 law. Instead, it should have raised the tax rate, sought additional power by the constitutional amendment procedure, or levied other taxes within its power.

We therefore contend that the 1932 Revenue Act cannot be so construed as to disallow the commissions of $7493.5[illegible] without rendering the Act unconstitutional to that extent.

V.

To the extent that the limitation provisions of Section 23(r) and (t) of the Revenue Act of 1932 may be construed by this Court as disallowing the buying commission in the amount of $7,493.50, such provisions are unconstitutional and therefore void under the Due Process clause of the Fifth Amendment to the Constitution because they create arbitrary, whimsical, and capricious discrimination against persons whose activities consist in part or in whole of buying and selling securities for profit.

This contention is made by respondent solely in the alternative and as in the previous point only in support of the judgment below allowing the deduction for buying commissions in the amount of $7493.50. This argument does not seek to attack the judgment below.

While it is not within the scope of the Fifth Amendment nor the Fourteenth Amendment to withhold the power of classification, if the law deals alike with all of the certain class, yet it is equally true that such classification cannot be made arbitrarily. In *Gulf C. & S. F. Ry. Co.* v. *Ellis*, 165 U. S. 150, 17 S. Ct. 255 this court said:

> "The state may not say that all white men shall be subjected to the payment of the attorney's fees of parties successfully suing them, and all black men not. It may not say that all men beyond a certain age shall be alone thus subjected, nor all men possessed of a certain wealth. These are distinctions which do not furnish any proper basis for the attempted classification. That must always rest upon some difference which bears a reasonable and just relation to the act in respect to which the classification is proposed, and can never be made arbitrarily, and without any such basis."

Again in *Connelly* v. *Union Sewer-Pipe Company*, 184 U. S. 540, 22 S. Ct. 431 this court said with regard to arbitrary classification:

"* * * This court has held that classification 'must always rest upon some difference which bears a reasonable and just relation to the act in respect to which the classification is proposed, and can never be made arbitrarily, and without any such basis * * * but arbitrary selection can never be justified by calling it classification.'"

A classification which favors persons engaged in the sale or exchange of stocks and bonds who happen to be "dealers in securities" as to stocks and bonds "acquired for resale to customers" in respect of transactions in the "ordinary course of business" over persons engaged in the sale or exchange who do not happen to qualify as "dealers in securities" or who do not happen to acquire the stocks and bonds for resale to customers even though such transactions are in the ordinary course of his business, is a purposeless, arbitrary, unreasonable, whimsical, and capricious discrimination in favor of persons in the former class. The distinction between these two classes creates a discrimination of an unusual character previously unknown to the practice of our Government. No sensible reason is apparent for the creation of such a peculiar and unusual differentiation between classes.

If a so-called "dealer" had "other income" equal to respondent's "other income" and had sustained losses on stocks held less than two years equal to respondent's similar losses, the so-called "dealer" would pay no tax. Or if respondent's trading or speculation loss had been in commodities instead of stocks, no tax would have resulted. Respondent's business is trading in stocks. What good reason is there for discriminating against him in favor of a so-called "dealer" or in favor of one whose business is trading in commodities?

As stated by McGeHee at Page 211 of his work 'Due Process of Law"

"* * * Clear hostile discrimination against particular persons and classes, especially such as are of an

unusual character, unknown to the practice of our Government, might be obnoxious to the constitutional prohibition."

In *Nebbia* v. *People of State of New York*, 291 U. S. 502, 525, 54 S. Ct. 505, 510, this court said in respect to the meaning of the due process clauses of the Fifth and Fourteenth Amendments to the Constitution,

> "The Fifth Amendment, in the field of federal activity, and the Fourteenth, as respects state action, do not prohibit governmental regulation for the public welfare. They merely condition the exertion of the admitted power, by securing that the end shall be accomplished by methods consistent with due process. And the guaranty of due process, as has often been held, demands only that the law shall not be unreasonable, arbitrary, or capricious, and *that the means selected shall have a real and substantial relation to the object sought to be attained*." (Emphasis ours.)

The purpose of a revenue law must be solely to collect revenue and not to discourage certain kinds of honest business activity. Such purposes not germane to the collection of the Revenue are arbitrary and if they are discriminatory without a reasonable and *just* relation to the matter of collecting revenue, or they become unjust and unreasonable and offensive to the Constitution.

That a Federal taxing statute may be so arbitrary and whimsical as to violate the "Due Process" provisions of the Fifth Amendment to the Constitution has been definitely determined by this court. In *Nichols* v. *Coolidge*, 274 U. S. 531, 542, 47 S. Ct. 710, 714, this court said as to "the arbitrary, whimsical, and burdensome character of the challenged tax" that:

> "This Court has recognized that a statute proporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment. Brushaber v. Union Pacific R. R., 240 U. S. 1, 24, 36 S. Ct. 236, 60 L. Ed. 493, L. R. A. 1917B, 414, Ann. Cas.

1917B, 713; Barclay & Co. v. Edwards, 267 U. S. 442, 450, 45 S. Ct. 135, 348, 69 L. Ed. 703. See, also, Knowlton v. Moore, 178 U. S. 41, 77, 20 S. Ct. 747, 44 L. Ed 969."

This court has since invoked this same principle in the following cases: *Helvering* v. *Helmholz*, 296 U. S. 93, 56 S. Ct. 68, 70; *Hassett* v. *Welch*, 303 U. S. 303, 311, 58 S. Ct. 559, 563; *Heiner* v. *Donnan*, 285 U. S. 312, 326.

Thus it is now clear that the prohibition against the Federal Congress in the Fifth Amendment to the Constitution that "no person shall * * * be deprived of * * * property, without due process of law * * *" is a limitation upon the taxing power of the Federal Congress and that arbitrary, whimsical, or capricious classifications or discriminations which result in the imposition of greater burden under one such classification than under another are void as repugnant to the said Fifth Amendment to the Constitution.

An example of the discriminatory effect of this capricious limitation is that persons engaged in buying and selling futures in the Chicago Grain Exchange may deduct their losses from such transactions from their other income while persons engaged in buying and selling securities on the New York Stock Exchange may not so deduct their losses from such transactions from their other income.

Why one method of speculation should be favored at the expense of another does not appear. The discrimination is wholly without substantial reason, *it rests upon no difference which bears a reasonable and just relation to the act in respect to which the classification is proposed*, and therefore renders the limitation provisions of Sections 23(r) and (t) of the Revenue Act of 1932 clearly arbitrary, whimsical, and capricious. The limitation is thus void as violative of the provisions of the Fifth Amendment of the Constitution.

Furthermore, the provisions of Section 23(r)(1) have the effect of applying the progressive rates of income tax

without relation to the taxpayer's "ability to pay." This circumstance destroys the reasonable basis for the discrimination otherwise inherent in the progressive income tax rate schedule. The only constitutional justification for the discrimination arising from the application of a graduated scale of rates in income taxation is the superior ability to pay of those upon whom the higher rates are imposed. Graduated rates must bear a reasonable relation to the current *increase* in net worth of the taxpayer resulting from transactions completed during the taxable year.

Losses of a taxpayer which occur in his trade or business reduce his net worth. Such losses must, therefore, be taken into account in applying a schedule of graduated rates based on ability to pay. Mr. Winmill had an actual loss of $145,000 during the taxable year, yet under the statute he must pay a normal tax on $35,000 and a graduated surtax on $52,000 although he actually sustained the large net loss.

The general principles governing this phase of the case were clearly stated by the Supreme Court in the case of *Stewart Dry Goods Co.* v. *Lewis*, 294 U. S. 550, 558, in which the Court said:

> "The district court found that 'generally speaking' he who sells more is in receipt of a greater profit and hence has larger ability to pay, and upon this basis justified the classification. But it is to be remembered that the act in question taxes gross sales and not net income. As stated in *United States Glue Co.* v. *Town of Oak Creek*, 247 U. S. 321, 328:
>
> " 'The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference

between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large.'

* * * * *

"The proofs submitted are insufficient to support the appellees' contention that the graduation of the tax was adjusted with reasonable approximation to the net earnings of the taxpayers.

* * * * *

"An income levy by its very nature assures equality of treatment, because the burden of the exaction varies with increase or decrease of return on capital invested and with the comparative success or failure of the enterprise.

* * * * *

"As we have said, the statute does not purport to levy a tax on incomes. Plainly it does not in fact do so. A merchant having a gross business of $1,000,000, but a net loss, must pay a greater tax than one who has a gross of $400,000 and realizes a substantial net profit.

* * * * *

"The law arbitrarily classifies these vendors for the imposition of a varying rate of taxation, solely by reference to the volume of their transactions, disregarding the absence of any reasonable relation between the chosen criterion of classification and the privilege, the enjoyment of which is said to be the subject taxed. It exacts from two persons different amounts for the privilege of doing exactly similar acts because the one has performed the act oftener than the other.

"We hold the act unconstitutional."

In *Heiner* v. *Donnan*, 285 U. S. 312, 327, 52 S. Ct. 358, 361, Congress levied a tax on transfers at death and to prevent its avoidance had imposed a tax which purported to be in the guise or name of a tax on a transfer in contemplation of death. Although it had the right to tax any transfer, it created a conclusive presumption, irrespective

of true fact, that transfers made less than two years prior to death were made in contemplation of death. This court held that presumption void as violative of the Fifth Amendment and likened such tax to a tax on one person based on another's property. In describing the effect of burdening one taxpayer with a tax measured in part by property belonging to another, this court said:

> "Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property of B, a result which both the Schlesinger and Hoeper Cases condemn as arbitrary and a denial of due process of law. Such an exaction is not taxation but spoliation. 'It is not taxation that government should take from one the profits and gains of another. That is taxation which compels one to pay for the support of the government from his own gains and of his own property.' United States v. Baltimore & Ohio R. Co., 17 Wall. 322, 326, 21 L. Ed. 507."

It is just as wrong to levy a tax in the name or guise of an income tax, which taxes only one's *successful* transactions during the year and ignores his unsuccessful ones, as it is to tax one person on another's income. In neither event is he being taxed on income which in true fact he enjoyed. The transactions resulting in losses have the effect of absorbing or turning into actual losses during the year the taxpayer's gains for the same period, thus impairing his ability to pay. Thus, while the Act professes to tax what in fact is income, Section 23 (r) (1) thereof creates a *conclusive presumption contrary to actual fact*, which results in taxing something which is not income.

The very illustration (used by this court in *Heiner* v. *Donnan, supra*), of a conclusive presumption contrary to fact, which could offend the due process clause of the Constitution, exactly fits the situation here, and we believe the imposition of such a tax is prohibited by the Constitution. In that case this court said at page 326 of 285 U. S., 52 S. Ct. 358, 361:

"That which is not in fact a taxpayer's income cannot be made such by calling it income."

CONCLUSION.

In view of the matters hereinbefore discussed, it is respectfully prayed that the judgment of the United States Circuit Court of Appeals below, allowing buying commissions as a deduction from income, be affirmed.

Respectfully submitted,

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